



STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	03/27/00	Bill No:	SB 1720
Tax:	Sales and Use	Author:	Wright
Board Position:		Related Bills:	SB 331 (Ch. 455, 1999)

BILL SUMMARY:

This bill would exclude from the terms “sale” and “purchase” the transfer of artwork, as defined, from a commercial artist, designer, or advertising agency to a customer or to a third party on behalf of the customer, if the customer does not obtain title.

ANALYSIS:

Current Law:

Under existing law, transfers of tangible personal property for consideration are subject to sales or use tax unless that transfer is specifically exempted or excluded from the computation of tax. The sales tax is based on the total gross receipts of retailers for the sale of tangible personal property, without any deduction on account of the cost of materials used, labor, or services that are a part of the sale of the property. “Sale” is defined in Section 6006 to include, among other things, any transfer of title or possession for consideration, as well as, generally, any lease of tangible personal property, which is the temporary transfer of possession without the transfer of title. Therefore, when tangible personal property is transferred, such as camera-ready artwork, even temporarily, to a person and a charge is made granting the person the right to reproduce the artwork (such as in a magazine), the entire charge is subject to tax. However, in order for tax to apply, there must be a tangible item of property transferred. Therefore, if artwork, for example, is transferred by remote telecommunication, modem to modem, no tax would apply to that transfer. On the other hand, if artwork is transferred in tangible forms, including transfers on electronic media such as diskettes or compact disks, the entire charge is subject to tax.

The Board’s Regulation 1540, *Advertising Agencies, Commercial Artists and Designers*, provides, among other things, that charges for a license, copyright, or subpart of a copyright (such as a right to reproduce or to prepare derivative works) to use the photograph or finished art are taxable if they are sold along with the photograph or finished art transferred by tangible media or they are sold by a subsequent contract entered into within one year of the original transfer of the photograph or finished art. However, these proposed regulatory changes also clarify that tax *does not* apply to a sale of an additional license, copyright, or the subpart of a copyright, or to the receipt of royalties received from the use of a copyright, if that sale or receipt of royalties occurs more than one year from the date of the original transfer of the physical media containing that photograph or artwork. Such copyrights or royalties are not considered

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to have been sold along with finished art transferred by tangible media and are therefore considered sales of nontaxable intangible property provided that the transfer of the additional license, copyright, or subpart of a copyright is by the original owner of the tangible personal property.

Proposed Law:

This bill would add Section 6010.60 to the Sales and Use Tax Law to exclude from the terms, "sale" and "purchase," the transfer of artwork, as defined in the Board's Regulation 1541, by hard copy or by electronic media from a commercial artist, designer, or advertising agency to a customer or to a third party on behalf of the customer, if the customer does not obtain title.

The provisions of the bill would become operative on the first day of the calendar quarter commencing more than 90 days after the bill becomes effective.

Background:

This measure is an outgrowth of two similar measures authored by Senator Wright that were considered in the previous two sessions. During the 1997-98 Legislative Session, SB 664 (Wright) was before the Legislature to provide a sales and use tax exemption for charges for reproduction rights associated with the transfer of artwork. As that measure was originally drafted, the Board estimated state and local revenue losses in the range \$110 million annually. Proponents asserted that the revenue loss was about half that identified by the Board.

To attempt to resolve these differences, the Legislative Analyst's Office (LAO) was asked to evaluate both estimates, but the LAO's findings did not lead to an agreement. It was concluded that making a more precise estimate of the revenue loss would be difficult, because specific data that were needed to definitively answer the question were not directly available. However, pursuant to a request by the LAO, Board staff reviewed sales tax accounts of 118 advertising agencies and graphic artists, and, based on the auditors' knowledge of the specific business activities of those accounts, estimated that those companies alone reported \$14 million in state and local sales and use tax on transactions that included the granting of a right to reproduce an original work of art.

Board staff met with proponents and, based on additional information they provided, revised some of its assumptions and revised its estimated state and local revenue loss to \$57 million annually. The sponsors of the bill also revised their estimate and concluded that the bill would result in a state and local revenue loss of approximately \$9 million annually. The bill was ultimately held in suspense in the Assembly Appropriations Committee.

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The issue was brought up again during the 1999 Legislative Session with the introduction of SB 331. As introduced, the bill would have also provided a sales and use tax exemption for charges for reproduction rights associated with transfers of artwork. The Board's analysis continued to indicate a \$57 million revenue loss associated with that measure.

This significant discrepancy in the estimated revenue loss associated with this issue has been repeatedly discussed, debated, and reviewed by Board staff, the bill's sponsors, and the Legislative staff assigned to analyze the bill. However, specific data needed to definitively resolve the question have not been directly available.

After being placed on the Senate Appropriations Committee suspense file, and to attempt to resolve the revenue loss estimate discrepancies, SB 331 was amended and subsequently enacted to require the Board, on or before January 15, 2000, to report to the Legislature on the total sales or use tax revenue collected in 1998 from any graphic artist, cartoonist, illustrator, commercial photographer, and advertising agency. In addition, the bill required that the report include sales and use tax assessed in audits of these taxpayers covering the 1997 calendar year.

The Board conducted the study and found that reported sales and use tax revenues for the calendar year 1998 for these industries amount to:

Advertising Agencies:	\$ 50,154,601
Graphic Artists:	\$ 46,487,731
Commercial Photographers:	\$ 6,919,121
Illustrators:	\$ 97,804
Cartoonists:	\$ 0
Total	<u>\$103,659,257</u>

And assessed sales and use tax revenues assessed (i.e. through audits) for the calendar year 1997 were:

Advertising Agencies:	\$ 354,828
Graphic Artists:	\$ 158,694
Commercial Photographers:	\$ 52,842
Illustrators:	\$ 9,855
Cartoonists:	\$ 0
Total	<u>\$ 576,219</u>

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COMMENTS:

1. **Purpose of the bill.** According to the author's office, this bill is intended to clarify that sales and use tax does not apply to charges for the intangible right to reproduce images. The sponsor of this measure is the Graphic Artists Guild.
2. **The March 27 amendments define "artwork."** The amendments reference paragraph (e)(3) of the Board's Regulation 1541, "Printing and Related Arts" for purposes of defining "artwork." The regulation states that artwork "includes, but is not limited to, illustrations (e.g., drawings, diagrams, halftones, or color images), photographs, drawings, paintings, handlettering, and computer artwork. ...". Although a definition of "artwork" is recommended for purposes of the proposed exclusion, it is recommended that the bill incorporate the actual definition within the statute. The Board updates and revises regulations regularly, and any specific paragraph reference to a Board regulation could result in an outdated or inapplicable reference in the statute in the future.
3. **Proposed exclusion could be extended to rentals of artwork.** The bill would create an exclusion from sales and use tax for transfers of artwork by an artist, designer, or advertising agency where title is not transferred. As drafted, this exclusion could apply to, for example, an interior designer's rentals of artwork. According to the author's office, this is not the intent of this measure. Accordingly, it is recommended that the following changes be incorporated:

6010.60. "Sale" and "purchase," for purposes of this part, does not include the lease transfer of artwork as defined in Section 1541 (e)(3) of Title 18 of the California Code of Regulations for reproduction purposes, whether leased in the form of a by hard copy or by electronic media from a commercial artist, designer, or advertising agency to a customer or to a third party on behalf of the customer, ~~if the customer does not obtain title.~~

4. **Enactment of this measure would exclude all reproduction rights associated with transfers of artwork.** Under the Board's Regulation 1540, sales or use tax does not apply to royalties from the use of a copyright, if those royalties are received by the original owner of the artwork more than one year from the date of the original transfer of the physical media containing the photograph or artwork. Therefore, enactment of this measure would both 1) broaden this exclusion to include those charges that occur during the *first year* from the date the artwork is transferred, and 2) codify the Board's regulation with respect to the exclusion for those charges in connection with royalties received more than one year *after* the date the artwork is transferred by the person receiving the royalties.

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COST ESTIMATE:

Costs would be incurred in notifying affected taxpayers and Board staff, amending applicable regulations, and answering inquiries. An estimate of these costs is pending.

REVENUE ESTIMATE:**Background, Methodology, and Assumptions**

There are a number of areas in which this measure would impact sales and use tax revenues.

Advertising Agencies

This measure would exclude from the sales and use tax, sales or purchases by an advertising agency that include the transfer of artwork to a customer or to a third party on behalf of the customer, where the customer does not obtain title, if the transfer occurs in California. This would include transactions involving an advertising agency receiving artwork from artists located outside of California when the use of the artwork occurs in California. The Sales and Use Tax Division conducted a study of advertising agencies, looking at their total gross receipts, their reported taxable transactions, and their sales or purchases of artwork that would be affected by this measure. The study investigated recent sales and use tax returns and audits of 67 advertising agencies. The study results showed that these 67 companies had total gross receipts during fiscal year 1996-97 of \$1,134.5 million, total taxable transactions of \$214.5 million, and taxable sales or purchases, that included the temporary transfer of artwork to a customer or to a third party on behalf of the customer where the customer did not obtain title, of \$55.5 million. Sales and use tax revenues derived from these transactions amounted to \$4.5 million. These taxable transactions represent 5% of the total gross receipts of these advertising agencies. ($\$55.5 \text{ million} / \$1,134.5 \text{ million} = 0.05$)

According to the U. S. Department of Commerce publication *1992 Census of Selected Services - California*, total 1992 receipts for advertising agencies amounted to \$1,771.3 million. If we factor this figure by the change in the California Consumer Price Index to a 1996-97 level, we get total receipts of \$1,932.5 million. We studied companies that accounted for \$1,134.5 million or 59% of this total.

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If we factor the 1992 receipts to a 2000 level, again using the change in the California Consumer Price Index and assume that transactions that include the transfer of artwork to a customer or to a third party on behalf of the customer, where the customer does not obtain title, amount to 5% of this amount, we can estimate the total amount of advertising agency receipts that would be excluded from the computation of sales and use tax under this measure.

1992 Advertising Agency Receipts	\$1,771.3 million
Percent Change in CCPI 1992-2000	19.9 %
Estimated 2000 Receipts	\$2,123.8 million
Percent Subject to SB 1720	5 %
Sales Subject to SB 1720	\$ 106.2 million
Sales and Use Tax Revenue @ 7.92%	\$ 8.4 million

Commercial Art & Graphic Design

This measure would exclude from “sale” and “purchase” transfers of camera-ready art created by commercial artists and graphic designers when the transfer includes the transfer of artwork to a customer or to a third party on behalf of the customer, where the customer does not obtain title. The Sales and Use Tax Department conducted a study, similar to the one done for advertising agencies, on 50 commercial artists and graphic designers. The study results showed that these 50 companies had total gross receipts during fiscal year 1996-97 of \$259.0 million, total taxable transactions of \$145.2 million, and taxable sales or purchases, that included the transfer of artwork to a customer or to a third party on behalf of the customer, where the customer does not obtain title, of \$116.7 million. Sales and use tax revenues derived from these transactions amounted to \$9.5 million. These taxable transactions represent 45% of the total gross receipts of these commercial artists and graphic designers ($\$116.7 \text{ million} / \$259.0 \text{ million} = 0.45$).

According to the U. S. Department of Commerce publication *1992 Census of Selected Services - California*, total 1992 receipts for commercial artists and graphic designers amounted to \$802.9 million. If we factor this figure by the change in the California Consumer Price Index to a 1996-97 level, we get total receipts of \$876.0 million. We studied companies that accounted for \$259.0 million or 30% of this total.

If we factor the 1992 receipts to a 2000 level, again using the change in the California Consumer Price Index, and assume that transactions that include the transfer of artwork to a customer or to a third party on behalf of the customer, where the customer does not obtain title, amount to 45% of this amount, we can estimate the total amount of commercial art and graphic design receipts that would be excluded from sales and use tax under this measure.

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1992 Commercial Art/Graphic Design Receipts	\$802.9 million
Percent Change in CCPI 1992-2000	19.9 %
Estimated 2000 Receipts	\$962.7 million
Percent Subject to SB 1720	45 %
Sales Subject to SB 1720	\$433.2 million
Sales and Use Tax Revenue @ 7.92%	\$ 34.3 million

Commercial Photographers

Commercial photographers, who take pictures for newspapers and magazines, rarely sell their photographs. They usually make a temporary transfer of the photograph and include the right to reproduce the photograph. As such, these transactions would be excluded from the application of sales and use tax under this measure. Mr. Harold Nelson, a CPA, and accountant for a number of commercial photographers in California, has estimated that between 40 and 55 percent of the work done by California's commercial photographers would be shipped out-of-state and would not be currently taxable. Since nearly all of the sales made by commercial photographers involve a temporary transfer of the photograph and include the right to reproduce the photograph, it would mean that between 45 and 60 of the receipts of commercial photographers would be for work transferred within California and would therefore be excluded from the sales and use tax under this measure. For the purposes of this estimate, we will assume that 45% of the gross receipts from commercial photographers would no longer be taxable under this bill. This is the same percentage we used for commercial artists and graphic designers and is within the range estimated by Mr. Nelson.

According to the U. S. Department of Commerce publication *1992 Census of Selected Services - California*, total 1992 receipts for commercial photographers amounted to \$182.4 million. If we factor the 1992 receipts to a 2000 level, using the change in the California Consumer Price Index and assume that transactions that include the transfer of artwork to a customer or to a third party on behalf of the customer, where the customer does not obtain title, amount to 45% of this amount, we can estimate the total amount of commercial photographer sales that would be excluded from the sales and use tax under this measure.

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1992 Commercial Photographer Receipts	\$182.4 million
Percent Change in CCPI 1992-2000	19.9 %
Estimated 2000 Receipts	\$218.7 million
Percent Subject to SB 1720	45 %
Sales Subject to SB 1720	\$ 98.4 million
Sales and Use Tax Revenue @ 7.92%	\$ 7.8 million

Royalty Payments for Transfers of Artwork

This measure would exclude from “sale” and “purchase” royalty payments for transfers of artwork to a customer or to a third party on behalf of the customer, where the customer does not obtain title. Based on information reported on tax returns from gift and art-goods stores in California, it is estimated that 2000 California retail sales of artwork reproduced for retail sale will amount to \$813.8 million. Assuming that California represents 12% of the nationwide sales of such items, U. S. sales of artwork reproduced for retail sale are estimated to be \$6.8 billion. These would include sales of both limited and open edition collectibles and prints. Limited edition means that only a specified number have been made and they are signed and numbered. The Graphic Artists Guild states that these limited edition collectibles are sold by the artists and these sales do not involve a transfer of reproduction rights. The Guild further states that most open edition collectibles are created with art either produced in-house, which would produce no sale of artwork and no royalty payment, or art purchased with a one time payment that includes no royalties. It estimates that perhaps only 15% of open edition agreements offer royalty payments.

The Graphic Artists Guild estimates that half of the retail sales of collectibles would be for open edition collectibles. It further estimates that California firms account for only 6% of the nationwide market in open edition collectibles.

According to a California retailer of collectible plates and figurines, the amount of royalty payments included in the sales price of these items varies from 1% to 10%, with 3% being a reasonable overall average.

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We estimate the total amount of royalty payments for works of art reproduced for retail sale to be as follows:

2000 U.S. Sales of Collectibles	\$6,800.0 million
Open Edition Collectible Sales	\$3,400.0 million
% of Sales with Royalties	15 %
Sales with Royalties	\$ 510.0 million
% Produced by California Artists	6%
Sales by California Artists	\$ 30.6 million
Royalty Payments @ 3%	\$ 918,000
Sales and Use Tax Revenue @ 7.92%	\$ 73,000

Greeting Cards

This measure would exclude from “sale” and “purchase” the transfer of artwork for reproduction on greeting cards, when the transfer includes the transfer of artwork to a customer or to a third party on behalf of the customer, where the customer does not obtain title. The Graphic Artists Guild has provided some figures on the U. S. greeting card market. According to the New York Times (November 20, 1997), the greeting card market in the United States amounts to \$7 billion annually. This market is dominated by three companies, none of which are located in California. These three companies account for 84% of the total market. California companies, according to *The Artist's Market*, account for approximately one quarter of the remaining 16% percent or 4% of the total U. S. market. This amounts to \$280 million. From information on audits, the Board has found that transactions that include the transfer of artwork to a customer or to a third party on behalf of the customer, where the customer does not obtain title, represent 7% of these sales. If the transfer of the artwork occurs in California, then the charges are currently subject to tax, and would no longer be subject to tax under this measure, regardless of where the artist is located or where the final sale of the greeting card occurs.

We estimate the total amount of royalty payments for artwork done in connection with greeting cards to be as follows:

2000 U.S. Sales of Greeting Cards	\$7,000.0 million
% Produced by California Companies	4%
Sales by California Companies	\$ 280.0 million
Royalty Payments @ 7%	\$ 19.6 million
Sales and Use Tax Revenue @ 7.92%	\$ 1.6 million

Book Publishing

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This measure would exclude from “sale” and “purchase” the transfer of images for reproduction in connection with book publishing. The Graphic Artists Guild was unable to provide us any exact figures on the percentage of the book publishing industry represented by California companies. It believes that California book publishing companies account for less than the normal 12% that California represents of total U.S. population. According to the U.S. Department of Commerce publication, *1992 Census of Manufacturers*, the total value of shipments by book publishers in the United States amounted to \$16,731.1 million in 1992. The value of shipments for California book publishers amounted to \$1,194.9 million, or 7% of the national total. If the transfer of the artwork occurs in California, then the transactions would be taxable currently and would not be taxable under this measure, regardless of where the artist is located and regardless of where the final sale of the book occurs. From information on audits, the Board has found that transactions that include the transfer of artwork to a customer or to a third party on behalf of the customer, where the customer does not obtain title, represent 7% of these sales. If we factor the 1992 receipts to a 2000 level, using the change in the California Consumer Price Index and assume that 7% of these sales would be subject to the provisions of SB 1720, we can estimate the total amount of book publishing receipts that would be excluded from sales and use tax under this measure.

1992 California Book Publishing Receipts	\$1,194.9 million
Percent Change in CCPI 1992-2000	19.9 %
Estimated 2000 Receipts	\$1,432.7 million
Percent Subject to SB 1720	7 %
Sales Subject to SB 1720	\$ 100.3 million
Sales and Use Tax Revenue @ 7.92%	\$ 7.9 million

Character and Trademark Licensing

This measure would exclude from “sale” and “purchase” royalties paid for character and trademark licensing when the royalties are paid in conjunction with a transaction that includes the transfer of artwork to a customer or to a third party on behalf of the customer, where the customer does not obtain title. Neither the Board of Equalization nor the Graphic Artists Guild could find any reliable information regarding the number of transfers of artwork involving the payment of royalties in connection with character and trademark licensing. The market for items that use these character and trademark designs is quite large. According to the magazine *Advertising Age*, 1995 national sales of these items amounted to \$70 billion. The Graphic Artists Guild believes that most, if not all, of the transactions that include the transfer of artwork in conjunction with the manufacture of these items occur outside of California. We have been unable to find any information to verify this. We will continue to research information regarding such transactions. However, it is our belief that the amount of such transactions would not materially affect the order of magnitude of the estimate of the revenue effect of this measure.

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Revenue Summary

The annual revenue impact from excluding from “sale” and “purchase” transactions that include the transfer of artwork to a customer or to a third party on behalf of the customer, where the customer does not obtain title would be as follows:

Type	2000 Sales (millions)	Revenue @ 7.92% (millions)
Advertising Agencies	\$106.2	\$ 8.4
Commercial Art & Graphic Design	433.2	34.3
Commercial Photographers	98.4	7.8
Royalty Payments	0.9	0.07
Greeting Cards	19.6	1.6
Book Publishing	100.3	7.9
Trademark Licensing	<u>not available</u>	<u>not available</u>
Total	<u>\$758.6</u>	<u>\$ 60.1</u>

The revenue effect on the various levels of government imposing sales and use taxes in California would be as follows:

	<u>Revenue Effect</u>
State loss (5%)	\$37.9 million
Local loss (2.25%)	17.1 million
Transit loss (0.67%)	<u>5.1 million</u>
Total	<u>\$60.1 million</u>

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Qualifying Remarks

Reliable information regarding transactions that would be affected by this measure was difficult to obtain. In some cases, neither the Board of Equalization nor the Graphic Artists Guild was able to uncover such information. The information regarding royalty payments for works of art reproduced for sale, greeting cards and book publishers is less than definitive. Especially in the greeting card and book publishing areas, there is a good possibility that some of the transactions included in these estimates are also included in the estimates for commercial art and graphic design. We have no information upon which to base an estimate of how much double counting there might be. However, the majority of the revenue loss estimate is based on a study of actual sales and use tax returns and actual revenues paid by advertising agencies and commercial artists and graphic designers. We feel therefore, that the \$60.1 million figure shown above is a reasonable estimate of the revenue effect of this measure.

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